Edison Electric Institute

Board of Directors Meeting

Remarks
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"Ensuring RTO Formation and Well Functioning Markets"

Chicago, IL
September 7, 2000

I. Introduction

Good morning. This is certainly an opportune time to address this distinguished gathering. We are at the end of quite an extraordinary summer for this industry and its restructuring efforts.

Some regions of the Nation experienced volatile and high wholesale electricity prices, and consumers in those areas are very concerned whether competition will produce the promised benefits. Consumers out west do not care that the weather was exceptionally hot and dry. They care about the bills they have to pay. California wholesale prices this year are multiples of last summer's prices. Officials of utilities that are operating under rate freezes are concerned about recovering their high purchased power costs. And rising prices in the Pacific Northwest are threatening the viability of the resource based industries in that region. State policy makers are also reacting. The Governor of California phoned and wrote to President Clinton, characterizing the problem as a "staggering rise in electricity prices."

Policymakers across the nation are watching California. A recent article in *MegawattDaily* quoted a supporter of deregulation in Iowa as saying that events in California have ruined the climate for restructuring in the Iowa Legislature. As another example, a recent piece in the Arkansas Democrat Gazette said that the Arkansas General Assembly may now consider pushing back the effective date of the new electricity competition law by four years. In short, confidence in electricity markets is being tested.

The good news to come of this summer's events, however, is that they rivet our attention on the question of what is needed for well functioning electricity markets. We are learning that certain elements are necessary, and we are seeing strong indications that all such elements are not in place. The Commission now has a valuable opportunity to investigate and understand electricity markets, to pinpoint market flaws and work to correct them. The Commission must seize this opportunity and pursue it forcefully. If we do not, this summer's events could repeat themselves, perhaps becoming even more widespread.

We must avoid that outcome. I have advocated reliance on competitive markets because I believe that competition will provide consumer benefits in the form of reliable power, attractive services, and prices that are ultimately lower than under cost of service regulation. We've learned, however, that markets for electricity do not magically or mysteriously occur. Instead, we must actively nurture those markets and ensure that all of the needed components are in place for markets to bear fruit.

II. Ensuring Well-Functioning Wholesale Markets

Well, what is needed for well-functioning wholesale electricity markets? I'd like to share with you my thoughts on this important question. But first, let me underscore that the Commission recently directed the FERC staff to conduct a thorough investigation of bulk power markets. The staff report is due November 1st. My observations and recommendations are made now without the benefit of the staff's conclusions, but here is my preliminary thinking. Some of these points are obvious ones, but others are more subtle.

A. Generation and Transmission Facilities

Policymakers must ensure that there are no impediments to expanding the supply of generation and transmission facilities. Markets will not work if supply cannot enter easily in response to demand. Many of the high prices this year and in other years have been attributed to a shortage of generators, or to constraints in the transmission network that prevent cheaper power from reaching the markets with high prices. I recognize that some of these shortages were the result of unforeseen events, or exceptionally hot weather or sustained demand growth due to the economy's continued strong performance. Nonetheless, necessary facilities must be sited and built for competitive markets to produce benefits. State siting authorities in California and elsewhere must respect this fundamental truth. Policymakers must ensure that reasonable and time limited siting rules are in place, balancing the need for new generation and transmission capacity with a responsible environmental policy.

Under existing law, the simple fact is that federal regulators can promote competitive wholesale markets, but we cannot site the facilities necessary for such markets to flourish and provide consumer benefits.

We do, however, have a say over generation interconnection policy. Well functioning markets need streamlined, standardized interconnection procedures and agreements in order to facilitate generation entry. I have been pushing for such a policy at the Commission. Streamlined and standardized interconnection procedures and agreements would cut down the time to get a plant on line and would help ensure that generating plants are sited according to the economics of the market and not according to the idiosyncracies of differing interconnection procedures. But the states have a role here too – not all interconnection authority resides at the federal level. The interconnection of many generators, including many applications of the promising distributed generation, is at the state level. Both we and the states still have a lot of work to do in streamlining and standardizing interconnection procedures and agreements.

Policymakers also must ensure that there is adequate transmission capacity to support competitive markets. There is widespread agreement that investment in new transmission is sorely lagging behind market needs. There are two facets to getting new facilities in place. One is to provide adequate financial incentives to encourage grid expansion. The Commission recently demonstrated its willingness to allow higher risk-based rates of return on transmission facilities in our Southern California Edison order. And I believe that performance-based rates and other incentives available to RTO members, which I will discuss later, will help to spur transmission investments. The Commission wants to play an active role in encouraging transmission expansion.

B. Siting Transmission Facilities

The most important issue, however, in the transmission equation may be siting. Here too, I believe that RTOs will help by providing a regional plan and a forum in which state authorities may coordinate.

I am not confident, however, that the current state-by-state approach to siting interstate transmission facilities will get the job done. I believe that the siting of interstate facilities should be carried out by an interstate authority. I continue to strongly recommend that Congress legislate federal siting authority with the power of eminent domain. This is one of the key issues on which I agree with Chairman Murkowski of the Senate Energy and Natural Resources Committee. FERC has such authority with respect to interstate gas pipelines and we have certificated literally thousands of miles of new pipeline capacity over the last few years. It will probably always be easier to site pipeline

capacity than it is to site high voltage transmission, but there is a solid rationale for the federal siting of facilities necessary for interstate commerce.

C. Market Design and Market Power

A second broad area that we must focus on is market design. We've learned a lot about electricity markets in the last year or so. One important lesson is that generation market power, even in an unconcentrated market, can be exercised during extreme demand conditions with very dramatic price impacts. In some high demand periods, it is impossible to meet all demand without relying on all of the available generation resources. The relatively high-cost generator operators – those on the upper end of the supply curve – know when these conditions are likely and can bid very high prices with a fair degree of confidence that they will be dispatched. In fact, these high demand conditions are often announced in advance. If the market rule is that the generator that clears the market sets the price for the entire market, all generators benefit from that exercise of market power. Thus, market prices can be manipulated by one or a very few sellers who do not face the risk of non dispatch if they bid too high. Generation entry is spurred by the price signal that results from a well-functioning market. But if a high market clearing price is pegged by market power, such an extreme price does not serve a legitimate market function. We should take a hard look at whether the single price auction is appropriate in high demand or short supply conditions.

This cause of high prices has been observed since the Commission approved the operation of auction markets with a single market clearing price. Perhaps we should reexamine our existing market power standards, which rely almost exclusively upon a generation dominance analysis. Is our analysis sophisticated enough? Perhaps we should fine tune our market power analysis so that we have a better chance to catch the potential for such behavior before it occurs.

D. Lack of Demand Responsiveness

Another critical issue is demand responsiveness. This is a standard means of moderating prices in well-functioning markets, but it is all but absent from electricity markets. When prices for other commodities get high, consumers can usually respond by buying less, thereby acting as a brake on price run-ups. Without the ability of end use electricity consumers to respond to prices, there is virtually no limit on the price that suppliers can fetch in shortage conditions.

We must urgently seek ways to increase demand responsiveness. There are two aspects to this. One is showing an accurate price signal to the consumer before

consumption decisions are made. The second is the ability of the consumer to react to the price signal. The first may be addressed by appropriate metering and communications. However, residential customers cannot easily respond to price signals. I don't believe any of us want to sit at home watching the hourly price signal so we know whether we should postpone dinner or adjust the thermostat. The capability for residential and even commercial customers to adjust consumption lies in so called "smart houses" or "smart buildings" that allow computers to adjust the operation of certain equipment in response to market prices and "strike price" instructions.

Until such "smart" technology has penetrated a large part of the market, I think electricity providers should concentrate on arrangements that compensate large industrial and large commercial customers for reducing consumption. That will provide the biggest bang for the buck and may even capture enough of the demand curve to help discipline price run-ups. It has also been suggested that RTOs operate demand-side markets where demand aggregators bid negawatts. All options are on the table. All reports I have seen have emphasized this lack of demand responsiveness as a critical problem. Working with the industry, we should attempt to solve it.

E. Risk Management

A key area that needs attention is risk management. In some instances, especially California, there seems to be an over reliance on the spot market. Spot markets are almost by nature volatile. While spot markets are appropriate as the venue in which to secure limited portions of needed supply, they should not be relied upon for most or all of the supply portfolio. Yet in California the spot market is relied upon almost exclusively. The painful results are almost predictable. The lack of hedging or forward contracting may be due to regulatory restrictions, or poor incentives. Whatever the reason, regulators must ensure that everyone on the demand side of the market is appropriately incented regarding hedging. There should be no hedging barriers. Surely a balanced portfolio of long-term and short-term supply is the goal of well-functioning markets.

F. Federal/State Partnership

State and federal authorities must form a partnership for ensuring well-functioning markets. Neither the FERC nor state policymakers, acting in isolation from each other, can solve all market flaws because our respective jurisdictions are sharply delineated under existing law. State policymakers cannot effectively define or police market power in interstate wholesale markets. They cannot require a wholesale market structure, based upon an efficiently operating interstate transmission grid, that will produce just and reasonable rates. These are federal responsibilities. By the same token, under existing

law the FERC cannot site the generation and transmission facilities that are necessary to bring supply and demand into equilibrium, and has no direct authority to require purchasers of power to hedge price volatility risk in forward or financial markets. These are state responsibilities. Both federal and state policymakers have a role in pursuing policies that will facilitate an effective and price-dampening demand side response. We must work together to solve the problems at hand.

G. Price Caps

Meanwhile, some are suggesting that we are going to have to live with some form of price caps or bid caps as stopgap measures. Although I have voted for these caps, I certainly do not relish this idea. I am aware that any sort of cap or intervention risks a watering down of the price signals we need for bringing about new supply and for hedging. While I firmly believe that price signals from a well-functioning market should be sufficient to attract generation, until we have good markets one could question whether we can rely on the resulting prices as appropriate signals. And one of the California lessons is that consumers do not want to bear the brunt of the price that results from flawed markets.

The bottom line is, the Commission has a statutory duty to ensure that wholesale prices are just and reasonable. This is the Commission's fundamental consumer protection responsibility, and the Federal Power Act provides no exception for flawed markets. We must insist that jurisdictional wholesale markets produce just and reasonable prices.

III. Getting RTOs Up and Running

Let me turn now to Regional Transmission Organizations. Let me say that I realize that RTOs are not a panacea for flawed markets. Nevertheless, I continue to strongly believe that the development of RTOs is a necessary platform on which to build well structured electricity markets.

A. Price Volatility Heightens Interest in RTOs

The Commission issued a clarion call for RTO development last December, and it is my impression that the recent price volatility in wholesale markets has heightened the Commission's interest in the getting good RTOs into operation.

Markets require open access to an efficiently organized transmission grid. RTOs that meet the requirements of the Commission's Order No. 2000 will help ensure access

to the grid, will enlarge power markets and improve grid operation through better transmission pricing, will establish regional planning processes that should facilitate improved siting decisions and result in more grid facilities, and will improve congestion management on the grid, thereby allowing more efficient use of the existing grid facilities. RTOs will also facilitate consistent market rules within a trading region.

These are important benefits, ones that must be realized if markets are to produce a reliable efficient supply of power for the Nation at reasonable prices. I want to underscore that the Commission realizes that providing transmission services has to be a viable business undertaking, one that is attractive to investors, and we are committed to making it so. Our commitment is demonstrated by two aspects of Order No. 2000.

B. Design Flexibility

One is flexibility. The backbone of Order 2000 is the characteristics and functions required of all RTOs. I believe that fulfilling each of those requirements is essential to the type of grid organizations needed to support wholesale markets. But in many instances, the Commission is allowing flexibility in how RTOs meet those requirements. For example, Order 2000 does not mandate the corporate form for an RTO. ISOs, transco, gridcos, or some hybrid form are acceptable. We do have some bedrock principles regarding independence from merchant interests and other characteristics. But each RTO is free to propose its own unique corporate form that meets Order No. 2000 standards.

Scope and configuration is another area where flexibility is allowed. The Commission did not dictate regional boundaries. Instead, we set out what we think are important determinants for scope and configuration. Market participants in the industry will know what works best from a reliability, operational, and market perspective. We have said that bigger is generally better, but we have not dictated boundaries.

C. Grid Pricing

Flexibility is also given to the all important issue of pricing. We will entertain any reasonable pricing proposal as long as it is fair, promotes efficient use and expansion of facilities, and does not charge multiple access fees for the recovery of capital costs, that is, no "pancaking." Order 2000 demonstrates the Commission's commitment to transmission as a viable business undertaking by outlining the innovative transmission pricing treatments that we will consider for RTOs. One important treatment for getting RTOs off the ground is a transmission rate moratorium based on formerly bundled retail transmission rates. In other words, we will ensure that transmission owners are not

penalized for moving their assets from state to Federal jurisdiction. Other notable innovative treatments outlines in Order No. 2000 are accelerated depreciation for new facilities, incremental pricing for new transmission facilities, and performance based rates. I believe that PBR, while difficult to design and implement, holds great promise for improving grid efficiency and rewarding good transmission operations.

D. Processing RTO Filings

Given what I see as an increased perception of the need for RTOs to facilitate market development, coupled with the flexibility for meeting our RTO requirements, I am increasingly yet still cautiously optimistic that the Commission will receive solid RTO proposals.

The deadline for RTO filings – October 15 – is fast approaching. Public utility transmission owners have two choices on the type of filing to make. One is to propose, or be part of a proposal for, an RTO that satisfies the Commission's requirements for characteristics and functions. The other much less appealing option is to file an explanation as to why you are not making an RTO filing and your future plans for doing so.

My advice is to propose an RTO that demonstrates a good faith effort to comply with all aspects of our rule. Given the flexibility that we've accorded, you should make a persuasive case for how your proposed grid organization satisfies the required characteristics and functions.

It is obvious that the Commission is very serious about RTO formation. An unprecedented amount of staff resources have gone into the outreach effort that preceded Order 2000, and into the collaborative effort that has been underway for the past nine months in all regions of the country. And the Commission's commitment to this policy is evident from the text of Order 2000 and the public comments of all of my fellow Commissioners.

The Commission is also serious about getting RTOs in operation by December 15, 2001. To meet that goal, I would hope that we will be able to give quick approval to the well supported proposals that we receive next month. For those proposals that fall short, but that demonstrate a good faith commitment to RTO formation, the Commission must respond with useful guidance and assistance aimed at getting the RTO operational by the December 15, 2001 deadline.

E. Commission Will Insist on RTOs

Given the Commission's firm commitment to this policy, I ask you to work with us to make it succeed. The Commission has more legal authority than it has thus far utilized to ensure RTO formation. I believe that the Commission will insist that an Order No. 2000 compliant RTO forms in every region of the country.

IV. Conclusion

In conclusion, the Commission has two major yet related tasks over the next 18 months. One is to work with industry to ensure the formation of RTOs. And second, building upon the RTO platform, to ensure that all elements are in place for well functioning wholesale markets.

Thank you.